

# Prospects for Korea-Japan Free Trade Agreement

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## Introduction

Until recently, East Asia lagged far behind Europe and North America in terms of regional integration. Since the late 1990s, countries in East Asia have aggressively joined the global FTA race and an intricate web of FTAs has been laid out throughout the region. More than twenty FTAs have been concluded while about twenty more FTAs are now in the process of negotiations. Following the trend of other Asian countries, starting in the late 1990's the Korean government shifted away from exclusive reliance on multilateral trading arrangement to actively seeking out regional trade agreements. Until 2003, Korea and Mongolia were the only two WTO member countries that had not concluded a single FTA despite the fact that there were already over 150 FTAs in effect around the world. As such, Korea was a latecomer in the FTA race, but has emerged rapidly to become a key player in the game. As of 2008, Korea now has four FTAs in force with Chile, Singapore, the European Free Trade Associations (EFTA), and with the ASEAN covering goods. In 2007 Korea successfully concluded the most significant FTA with the world's largest economy, the United States. Negotiations with Canada, India, and the European Union are also well underway. Further negotiations with the ASEAN on services and investments are right on track and proceeding smoothly. If all these on-

going negotiations are concluded successfully, the number of countries with which Korea will have signed a free trade agreement would reach dozens.

Despite the flurry of activities with other countries, FTA negotiations with Japan have been stalled since 2004. Korea and Japan first began discussing FTA negotiation in November 1998. After series of academic symposiums and business forums, the stage was ripe when President Roh Moo-hyun visited Japan in June 2003 and agreed for speedy conclusion of FTA. Governmental discussions began in December 2003, but after six rounds of bimonthly shuttle diplomacy all negotiations were suspended in November 2004. The trade talks have been blocked because of Korea's reluctance to further open its automobile market and other manufacturing industries while Japan objected to fully opening its agriculture market.

Meanwhile, Korea of course pursued FTA with other countries such as Chile, Singapore, ASEAN, and the U.S. Korea's first FTA was concluded with Chile in 2004. Although Chile is not Korea's major trade partner, the negotiations can be considered as prelude for a much larger FTA negotiation. Korea-US FTA was successfully concluded on April 2008. With the success of Korea US trade negotiation on his back, President Lee Myung-bak visited Japan on April 2008 and agreed with Prime Minister Yasuo Fukuda on continuing FTA negotiation. But the two leaders only agreed to let "working-level" officials discuss the commerce issue. Under their "limited" consensus, the two countries held a working-level meeting June 25 to fine-tune how to resume stalled negotiations for an FTA.

Almost four years have passed since the government discussions, but issues such as agricultural liberalization and non-tariff barriers still remains to be worked out. Most recently, issue of Dokdo has clouded the horizon for improving Korea-Japan relationship. The main difficulty with Korea Japan

FTA is that Korea's tariff rate in general is higher than Japan's, so it is perceived by many Koreans that the elimination of tariff brings economic losses to Korea. Furthermore, Korea historically has had substantial trade deficit with Japan. Therefore it is important for Japan to take positive leadership and offer appealing incentives so that Korea can negotiate in earnest.

### **History of Preferential Trade Agreement**

The European Union was envisioned by European leaders who believed closer economic cooperation was required for lasting peace in Europe. Devastated after the Second World War, Europeans wanted to permanently end the frequent and bloody wars between countries and to secure lasting peace. In 1951, the European Coal and Steel Community, which was supranational treaty to form common market for coal and steel, was set up as a prelude to unite European countries economically and politically. In 1969 ECSC has transformed to European Economic Community, and by 1993 the Single Market is completed with the four freedoms of movement of goods, services, labor and capital. The six member countries of ECSC have now become European Union (EU), a political and economic union of twenty seven countries. With almost 500 million people, the EU generates about 30% of the world GDP (\$16.8 trillion in 2007).

Similarly North America's FTA can trace its history with U.S. Canada Auto Pact Agreement in 1965 which allowed duty free trade for trucks and cars. Under the U.S. Canada FTA agreement, both countries agreed to phase out all tariff barriers over the next decade, beginning in 1989. The U.S. and Canada have the world's largest bilateral trade relationship, exchanging yearly over \$550 billion in manufactured goods. Over 20 percent of U.S.

exports go to the Canadian market, while Canada sends over 75 percent of its exports to the U.S. Eventually, North American economic tie was extended to Mexico and NAFTA agreement came into effect on January 1, 1994.

### **Effect of FTA on Korea's Trade**

Today there are over 150 regional or preferential trade agreements in the world. Korea in that sense began very late as even as late 1990s Korea followed strictly multilateral approach to world trade. In 1999 Korea began FTA negotiation with Chile and within three years concluded FTA agreement. Since then, Singapore, EFTA, and ASEAN followed. As for U.S. the last step of ratification by the congress in both sides remains. The country is also in negotiation with Canada, Mexico, India, EU, and Japan.

The effect of FTA as seen from Korea's trade with Chile indicates that trade indeed is promoted with free trade. Table 1 shows growth of export and import before free trade and after free trade. Korea-Chile free trade agreement became effective in March of 2004. Korea's exports to Chile were stagnant for many years prior to FTA and stood at about \$517 million in 2003. But by 2007, exports increased to \$3,115 million, an astonishing six-fold increase in the span of just four years. Imports from Chile shot up also from about \$1,058 million in 2003 to \$4,184 million representing four-fold increase. In the meantime Korea's total exports rose from \$197 billion in 2003 to \$379 billion in 2007 representing 92% increase and Korea's total imports rose from \$175 billion to \$350 billion representing 100% growth. Although Chile is not among Korea's major trade partner, the impact of free trade agreement is clear as exports and imports all increased multiples of times higher than overall exports and imports. The trade growth is impressive since the

distance that separate Korea and Chile is close to 11,000 miles. It is ironic that Korea and Japan are such a close neighbors yet there is no free trade agreement between the two.

Table 1. Korea Chile Trade Volumes

(\$million, percent change)

	2001	2002	2003	2004	2005	2006	2007	2008
Exports (percent change)	573 (-3.4)	454 (-20.7)	517 (13.9)	708 (36.9)	1,151 (62.5)	1,566 (36.1)	3,115 (98.9)	2,187 (12.8)
Imports (percent change)	696 (-22.8)	754 (8.3)	1,058 (40.3)	1,934 (82.8)	2,279 (17.9)	3,813 (67.3)	4,184 (9.7)	3,252 (13.4)
Trade balance	-123	-300	-541	-1,226	-1,122	-2,247	-1,069	-1,065

Source: Korean International Trade Association

Data for 2008 is for January to August.

### Sluggish Trade Growth

Table 2 shows Korea's trade with Japan from 2002 to 2007. Historically Korea runs chronic trade deficit with Japan. The deficit is structural because Korea relies heavily on Japan for intermediate and capital goods in order to export.

In 2002 Korea's exports to Japan amounted to \$15.1 billion and increased to \$26.4 billion by 2007 which is a 75% increase over the five years. Meanwhile Japan's export to Korea increased from \$29.9 billion in 2002 to \$56.3 billion in 2007 representing 88% increase over the period. As a result trade deficit rose from \$14.7 billion in 2002 to \$29.9 billion in 2007.

Unlike Korea-Chile trade, Korea-Japan trade is increasing at the lower

rate than the overall growth rate of Korea's trade. Total exports increased from \$163 billion in 2002 to \$379 in 2007 which is 133% increase and total imports rose from \$149 billion in 2002 to \$350 billion in 2007 which is 135% rise. In other words Korea's export to Japan is increasing at only 56% of the rate of overall export growth rate. And despite Korea's huge and mounting deficit with Japan, imports from Japan are growing at a rate below the overall average growth rate as it grew 88% while total imports grew at 135%. Japan's imports are growing at 65% the rate of total import growth.

Table 2. Korea-Japan Trade

(\$billion, percent change)

	2002	2003	2004	2005	2006	2007
Exports	15.14 (-8.3)	17.28 (14.1)	21.70 (25.6)	24.03 (10.7)	26.53 (10.4)	26.37 (-0.6)
Imports	29.86 (12.1)	36.31 (21.6)	46.14 (27.1)	48.40 (4.9)	51.93 (7.3)	56.25 (8.3)
Trade balance	-14.71	-19.04	-24.44	-24.38	-25.39	-29.88
Total trade	45.00	53.59	67.84	72.43	78.46	82.62

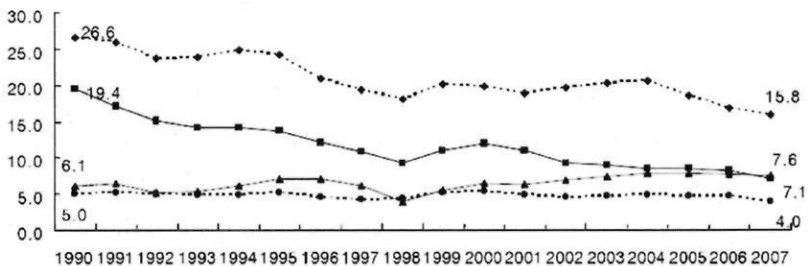
Source: Korean International Trade Association

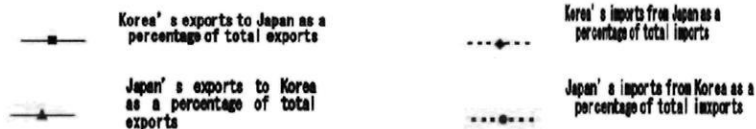
Unlike Chile, Japan is Korea's important trade partner. In Korea's export market, Japan ranks third in importance following China and U.S. In imports, Japan is second only to China. Total trade volume with Japan represents almost 10% of Korea's GDP. From Japan's point of view Korea is a very important export market ranking third after U.S. and China. But on the import side, Korea is only sixth in importance following China, U.S., Saudi Arabia, U.A.E., and Australia. Since Japan is a huge importer of raw material, if we disregard the raw material importing countries, Korea still ranks third after China and U.S.

Despite being an important partner, the data shows that the growth in trade is sub par. In order to exploit the dynamic comparative advantage of both countries they must work on opening up the market to freer trade, eliminate nontariff barriers, and facilitate foreign direct investment. Gravity model of international trade states that other things equal, trade between neighboring countries should be more active. In that light there should be more trade between Korea and Japan. At the least, both countries' trade should increase at the same rate as average trade volume increase.

Table 3 shows Korea and Japan's trade interdependence over the period 1990 to 2007. It is interesting to note that Korea has managed to diversify its trade over the last two decade and trade dependency on Japan gradually fell over the period. In 1990 Korea's export to Japan was 19.4% of total exports and imports from Japan was 26.6% of total imports. By 2007 dependence on Japan fell as export share fell to 7.6% and import share fell to 15.8%. On the other hand Korea has become more important for Japan at least for the export side. In 1990 Japan's export to Korea was 6.1% of total exports and imports from Korea was 5.0% of total imports. By 2007 dependence on Korea increased as export share increased to 7.1%. The import share over the period fell to 4.0% of total Japanese import.

Table 3. Korea-Japan Exports and Imports Shares





### An Empirical Analysis: Asymmetry in Import Demand Functions

A simple ordinary square regression is run for Korea and Japan's import demand function. Annual data is used for period 1971 to 2006 for Korea and for 1980 to 2003 for Japan for lack of available data set.

Equation (1) shows regression result for Korea's import from Japan.

$$(1) M_k = 3.16E+9 + 0.068(Y_k) - .94E+8(e_r)$$

$$t = 0.81 \quad t = 18.70 \quad t = 1.23$$

Equation (2) shows regression result for Japan's import function.

$$(2) M_j = -2.57E+12 + 0.0067(Y_j) + 1.05E+11(e_r)$$

$$t = 9.92 \quad t = 11.00 \quad t = 2.80$$

where  $M_k$  is Korea's real import from Japan,  $Y_k$  is Korea's real GDP and  $e_r$  stands for real exchange rate calculated as won/yen exchange rate times Japan export price index over Korea export price index. Korea's real imports and GDP is measured in dollar terms. Likewise  $M_j$  stands for Japan's real import from Korea and  $Y_j$  stands for Japan's real GDP. For Japan, real imports and GDP is measured in Japanese yen terms.

In both regressions income is highly significant in explaining imports whereas for the real exchange rate, it is not significant for Korea's import demand function. However the real exchange rate is significant in explaining Japan's import from Korea. For both countries  $R^2$  is quite high - 0.932 for Korea and 0.937 for Japan.



However, Durbin Watson statistics is low for both countries - 1.07 for Korea and 1.01 for Japan indicating positive serial correlation. Further research on regression specification is required but the simple ordinary least square estimation is acceptable for our purpose.

As can be seen from the regression results, there is asymmetry in import demand functions. Korea's real GDP increase of \$1 raises real import from Japan by \$0.068. On the other hand Japan's real GDP increase of ¥100, roughly equivalent to \$1, increases Japan's real imports from Korea by ¥0.67 (about \$0.0067). In other words, for \$1 increase in GDP, Korea tends to import 10 times as much of Japanese goods compared to Japanese imports of Korean goods.

### **Prospects of Asian Regional Integration**

A century from today, the world may be globalized to a level beyond what we can imagine now. Due to political necessity perhaps, after the Second World War, Europe has taken a lead in terms of economic, monetary, and political integration. EU covers vast area of Europe with population near 500 million and the economic size that is 30% of world GDP. In the Western hemisphere NAFTA was established since 1994 and eventual plan is to encompass Southern hemisphere as well. In that light Asia is way behind the other major economic blocks. Huge differences in size, power and level of development among countries in the region and strong rivalry between China and Japan may serve as stumbling blocks to regional integration.

In Asia, ASEAN was the first meaningful regional FTA and therefore it is natural that ASEAN is trying to retain the initiative in the process of regional integration. They also fear that the dynamic center of the region is likely to shift to Northeast Asia, thereby marginalizing the ASEAN in the

process. Asian economic integration must deal with ASEAN's resolve to keep the driver's seat in the process. Another question is whether or not and how to engage the U.S. in the process. Finally, there is a question of who will take on a leadership role. Nor is there a country in East Asia to lead the process as the U.S. has done with NAFTA. Neither Japan nor China would take the leadership role and, even if they did, it is not clear whether others would willingly follow.

As difficult as it entails however, East Asia regional integration must take place before for the meaningful Asia wide regional integration and the first step in the process necessarily involve Japan and Korea. If Japan seriously envisions East Asia free trade area, Japan has to show leadership and provide incentive for Korea to accept FTA. The agenda should not be just limited to goods but encompass free movement of labor, more extensive investment in Korea by Japan (Korea's share of Japan's FDI is only 1%), facilitation of service trade and complete elimination of non tariff barriers

In order to take advantage of dynamic effects of free trade Korea Japan FTA should go beyond just the elimination of tariff. To be truly integrated, for example, each country should offer right of residence. In Europe for example, EU citizens no longer need to obtain a residence permit in the Member State where they reside. After five years of uninterrupted residence, Union citizens and their family members can acquire a permanent right of residence, which will no longer be subject to any conditions.

Therefore, success or failure of East Asian regional integration largely depends on whether or not and how Korea and Japan reconcile and harmonize the different economic, political and strategic goals of major players in the region. World trade talks collapsed after seven years of on-again, off-again negotiations. The failure appeared to end, for the near term

at least, any hopes of a global deal to further open markets and strengthen the international trading system. Stalemate of Doha Round and concomitant increase in the economic influence of regionalism necessitates stronger regional economic ties for Korea and Japan. Although modern history of Japanese colonialism was unfortunate for Korea, the two countries have had cultural and economic ties going back many centuries. And Korea-Japan FTA is a natural stepping stone for a wider East Asia FTA. Both countries must work together to build upon the progress made thus far, further strengthen the growing sense of community, and spread the trend of reform and liberalization throughout the region.

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